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United States Senate

COMMITTEE ON
GOVERNMENTAL AFFAIRS

SUBCOMMITTEE ON
CIVIL SERVICE, POST OFFICE, AND
GENERAL SERVICES

WASHINGTON, D.C. 20510

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Policy Forum

Employer Retirement Programs and Social Security

April 17, 1984

1:00 p.m. - 5:00 p.m.

Dirksen Senate Office Building Room SD106

- | | |
|--|---|
| I. Social Security: Structure/Benefits/Contributions | Lawrence Thompson
U.S. General Accounting Office |
| II. Overview: Coordinating Pensions with Social Security
(How it is done today) | Charles E. Ginsberg
Alexander & Alexander Inc. |
| III. Options: Coordinating Pensions with Social Security
(Alternative approaches--full range) | Manuel Castells
Kwasha Lipton |
| IV. Issues and Complications | John Fleming
Bakery and Confectionary Union
& Industry International
Health Benefits & Pension
Funds
Keith J. Goodell
United Technologies Corporation |

Remarks by John J. Fleming, Administrative Director
Bakery and Confectionery Union and Industry International Health
Benefits and Pension Funds

Introduction

Personal role in Private Pensions --

Not a spokesman for B.C.&T or any Union -

Rather a neutral observer of Private Pension Community

B&C Fund

Number of Pensioners

Number of Participants

Amount of Assets

Percentage of Funding

Review of benefits currently being paid monthly to pensioners. Consideration of what it would be like without those benefits.

Four Major Issues

1. Control of funds and investment of funds.
2. Defined Benefit or Defined Contribution.
3. Integration with Social Security or non-integration.
4. Contributory or non-contributory.

Historical Perspective

Three Eras

- I. Pre - 1949
- II. 1949 - 1974 (ERISA)
- III. Post ERISA

Pre 1949.

Types of Plans in existence

- a) Mostly company plans
- b) Limited amount of coverage in terms of numbers of people.
- c) Railroad Retirement System was in existence.
- d) United Mine Workers had begun Multiemployer Plan.

Issue I.

Control of investments and rules and regulations of the Plans were the exclusive domain of the Employer who was the sponsor of the Plan . Contained bad boy clauses and were generally considered a generous provision of the employer who had set them up voluntarily without the pressures which came into play later.

Issue II.

They were generally defined benefit although there were defined contribution plans in effect as well. It is interesting to note that the first regulation in the Internal Revenue Code dealt with profit-sharing plans rather than pure pension plans.

Issue III.

Integration or non-integration -- The original regulations on integration were written during this period after Social Security had become effective. It is interesting to note that Social Security was written in such a fashion as to tilt in favor of the lower paid worker and the Integration Rules of the Internal Revenue Code are written in such a fashion as to correct the tilt.

Issue IV.

Contributory or non-contributory -- Many of the Plans in existence before 1949 did provide for contributions but I have not been able to get statistics which would tell us whether they constituted a majority. My guess is that they did not but that is simply a guess.

Era II - Post 1949 --

The Supreme Court decision re Inland Steel vs. United Steelworkers provided for bargaining for pensions.

Shortly thereafter a wage freeze because of the Korean Conflict occurred.

The two events acted as double doors for the spectacular growth of Pension Plans.

Several years previous the National Labor Relations Act of 1947 was written. Its purpose was to show the growth of collective bargaining and it probable succeeded but it also had an unintended effect. It established the framework for Multiemployer Plans which were then known as Taft-Hartley Funds.

Issue Number I.

Control of the Funds and Investment of the Funds --
The possibility of Taft-Hartley Funds made it feasible to establish craft wide pension funds either on a local, regional or national basis - indeed several

are international because they cover the same crafts in Canada as well as the United States.

The investment of the funds that resulted were the responsibility of a joint Board of Trustees composed of Union Trustees and Employer Trustees.

This methodology was particularly appropriate for the Construction Trades where there were many small employers who could not economically provide the same pensions as a large trust.

The large industrial unions negotiated the benefits and the terms under which the benefits were to be paid but the management of the assets remained in the hands of each individual employer.

Issue II.

Defined Benefit or Defined Contribution -- The Plans which fall into the two categories above, that is, multiemployer funds and single employer negotiated funds were nearly universally defined benefit funds.

Issue III.

Integration or non-Integration -- Unions in their collective bargaining posture strongly resisted Integration.

I know of no multiemployer fund that provides for integration although some might exist. The vast majority of negotiated single employer plans with which I am familiar also do not contain provisions for integration although some certainly exist.

Issue IV.

Contributory or Non-Contributory -- Again, multi-employer plans have resisted any form of individual contributions.

In single employer collectively bargained plans the unions also resisted individual contributions although again such plans do exist.

The spectacular growth of pension plans continued through the 50's and on into the 60's.

As can be expected with such growth and the paucity

of legislation or regulation abuses to the system crept in and legislation was proposed for many years to bring the abuses to a halt. Ultimately in 1974 we ended up with ERISA which marked the end of an era but unmistakably created a whole new era of its own.

There seems to be a principle that proposed legislation grows rather than condenses by the time it is written. That principle we certainly observed in ERISA. By the time of its enactment it had swollen to 278 closely typed pages.

Post ERISA

Perhaps the single most publicized event leading to ERISA was the collapse of the Studebaker Company and the concomitant collapse of the Studebakers Employees' Pension Plan.

Issue I.

Control of Funds and investment of Funds -- One of the cornerstones of ERISA was the "Prudent Man Rule". In the Studebaker situation the company had elected to invest the Pension Funds in the Company itself.

When the Company collapsed the portfolio of the employees pension plan was worthless and those employees, after many years of work for the Company had no benefits whatsoever.

In a position paper several years ago the Industrial Union Department has gone on record to advocate that where possible the control of pension funds be shared equally by union and management as presently exists in the Multiemployer field.

Issue II.

Defined Benefit or Defined Contribution Fund --
Another feature of ERISA was the establishment of the Pension Benefit Guarantee Corporation.

That insurance has protected tens of thousands of participants who would otherwise have lost their pension because of Plan failure. More recently M.E.P.P.A. was enacted to provide the same protection to Multiemployer Funds through the use of a different mechanism (Withdrawal Liability). The provisions of ERISA have caused plan designers to take a hard look at their plans.

A defined contribution plan does not participate in the P.B.G.C. scheme and thus costs and reporting requirements are eliminated. Additionally unfunded liability doesn't exist and thus doesn't appear either as a footnote or on the balance sheet.

Because of these reasons there has certainly been a favoring of defined contribution plans even those plans contain weaknesses as regards the participant.

I believe unions will continue to resist defined contribution plans unless they are an addition to an already existing defined benefit plan.

Issues three and four have remained the same across all three eras and will undoubtedly continue on into the future.

CONCLUSION

I would be evasive if I did not here include a fifth issue which has arisen in the recent past but which I believe contains a great deal of future debate and disagreement.

That issue is the termination of over funded plans and the re-capturing of excess assets. The principle involved can be stated simply.

Does the money in the portfolio belong to the persons on whom it was contributed or, if the promise is fulfilled, does money over and above the promise belong to the employer?

This problem is heavily impacted by the defined benefit or defined contribution controversy as well as the unfunded liability controversy and will in my opinion heat-up in the immediate future.

And so the industry goes on with old and new controversy but as I indicated in my opening remarks, I would hate to think of our society and our economy without it.

PRESENTATION PREPARED FOR
UNITED STATES SENATE
COMMITTEE ON GOVERNMENTAL AFFAIRS

POLICY FORUM APRIL 17, 1984
EMPLOYER RETIREMENT PROGRAMS
AND SOCIAL SECURITY

Keith J. Goodell
United Technologies Corporation
Hartford, CT

Pension Integration - Issues and Complications

Keith J. Goodell

United Technologies Corporation

I am grateful for the opportunity to present our views on pension integration and to discuss some of the issues in designing an integrated pension plan.

United Technologies Corporation sponsors 50 domestic pension plans covering over 100,000 employees. Our plans provided \$160 million of benefits in 1983 to 40,000 retired members. Plan assets equal \$3.5 billion. In 1984 UTC will contribute \$203 million to fund the pension plans.

UTC also contributes to another pension program ... Social Security. The 1984 contribution for Social Security retirement benefits will be \$140 million. Our employees will contribute an equal amount. This is exclusive of our contribution to the Health Insurance component of Social Security.

The 50 UTC plans can be categorized into plans which are implicitly integrated with Social Security, generally plans covering union employees, and plans which are explicitly integrated, generally plans which cover employees not represented by a union. I would like to concentrate on the latter category: the explicitly integrated plans.

Let us consider the characteristics of the largest UTC pension plan, which is explicitly integrated:

33,000 employees
21,000 retirees
\$2.2 billion assets

The retirement benefit formula is:

2% salary times the first 20 years service and 1% salary times service after 20 years, integrated with 50% of Social Security benefit.

For our average employee the monthly benefit will be:

UTC Pension	\$ 850
Social Security	<u>750</u>
Total	\$1,600

For employees at the lower and higher income ranges, the monthly figures are:

	<u>lower salary</u>	<u>higher salary</u>
UTC Pension	\$ 600	\$2,070
Social Security	<u>550</u>	<u>750</u>
	\$1,150	\$2,820

Social Security benefits are better as a percent of pay for low wage earners. The system was designed that way to meet the basic needs of all retired workers. It is appropriate for a national social program to emphasize social adequacy.

UTC's pension program was designed with a goal of equitable benefits for all employees across the earnings range. Thus we believe a medium or higher paid employee should receive a benefit percentage from the combination of Social Security and our pension plan that is commensurate with the percentage for a lower paid employee, given similar service. Differences in the benefit percentages should reflect work related expenses, relative tax positions and amounts of disposable income. We have chosen to emphasize individual equity. Applying the rules for integration to our plan produces a combined benefit percentage (replacement ratio) which decreases as compensation increases, although not to the same degree as does the Social Security benefit by itself.

Let us review the two major considerations that all plan sponsors should start with in designing an integrated pension plan. We would attempt to set a benefit level sufficient to attract, retain, and motivate competent employees. Benefits would be large enough to allow aging employees to retire with financial security. We would also determine the cost of the benefit program and adjust the benefit level as necessary.

In setting an appropriate benefit level we need to take Social Security into account. If we did not, one of two results would occur:

- o certain employees would receive very high combined benefits while other employees would receive inadequate benefits.

- o the cost of the program would be substantially higher than justifiable.

UTC does not have an unlimited budget for the proper funding of our pension program. Thus we cannot ignore the substantial benefits our employees derive from the Company contribution to Social Security. Integration with Social Security allows the most efficient benefit delivery for all employees from the contribution level that we have allocated.

A public employee retirement plan funded through tax revenue has the same considerations when the participants are covered by Social Security. A benefit structure must be designed to meet the retirement needs of a broad spectrum of employees, and at the same time avoid an undue financial burden on the taxpayers.

ISSUE

Consider the salary range for the group of employees to be covered by a new pension plan. If a narrow range exists, the Social Security replacement ratio is about the same for all employees. Integration can be accomplished implicitly, and the complementary pension replacement ratio can be determined.

If the salary range is broad, proper integration can only be accomplished explicitly, i.e., by directly mentioning the Social Security benefit in the pension plan formula:

Examples:

- o 50% of final average pay integrated with 50% of Social Security benefit
- o 1½% of final average pay integrated with 1½% of Social Security benefit, for each year of service, maximum 35 years

ISSUE

Social Security benefits are calculated using the earnings over an employee's entire career. How much credit for Social Security benefits should the company take for someone who is not a full career employee? There are basically two ways this is now handled:

- o calculate the Social Security benefit using only earnings while in company employment,
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UTC uses the first method in determining Social Security benefits for our integrated benefit formula. Note, however, that government regulations do not require any reduction in the integrated Social Security benefit for employees with less than a full career with the company.

ISSUE

What if an integrated formula results in little or no pension benefit for lower paid employees? One solution would be to increase the pension formula for everyone. This is the expensive way. A better way is to establish a minimum benefit from the pension plan.

For example:

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ISSUE

One of the major issues in inflationary times is the relative roles of Social Security and pensions after retirement. None of UTC's pension plans contains an automatic increase provision for post-retirement inflation. Such a provision is expensive and is uncommon among large companies.

Instead, in periods of high inflation, a company will often grant one time adjustments to current pensioners to help them maintain their standard of living at retirement. UTC granted such an increase, called an "ad hoc" increase, in 1979. There are three reasons we have not given additional ad hoc increases:

- o they are quite expensive,
- o Social Security benefits are fully indexed for inflation,
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It is interesting to note that a lower paid employee receives a larger proportion of his total retirement benefit from Social Security than a higher paid employee. Thus the lower paid employee has a greater degree of inflation protection and is better able to maintain his standard of living at retirement. Higher paid employees, with relatively less inflation protection, generally have other sources of financial security to help maintain their standard of living.

In addition to our basic pension plan, UTC also sponsors a defined contribution savings plan. This plan is viewed as a supplemental plan. The company matches 50% of the employee's contribution of up to 6%. Assets accumulated at retirement will help improve our employees' financial security. Our savings plan is not integrated with Social Security.

ISSUE

With all the complex calculations for Social Security benefit determination, how can an integrated system be efficiently managed?

It is imperative to rely on a computer system for benefit calculations. The system must be reliable, efficient, and flexible. At UTC we maintain employment records for 60,000 employees on our data base system. When an employee is contemplating retirement, our pension technicians work interactively with the system to produce a pension status sheet. This provides a summary of all benefit and options. The Social Security benefit is automatically calculated through a subroutine installed and maintained by our actuarial consultant. The pension status sheet allows a retirement counselor to discuss accurate pension benefits with each employee nearing retirement.

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What are the considerations in communicating benefit information to employees? An integrated benefit formula has the stigma of being difficult to communicate. This is likely due to the negative connotation of an "offset" component in the formula.

The most effective way to tell an employee about his pension benefit is to give him a personalized benefit statement. UTC provides annual benefit statements to all employees covered by the integrated pension plan. Accuracy and clarity are essential in benefit statements. The data for calculating benefits is accessed from the same data base used for recordkeeping.

Our benefit statement shows the benefit an employee is expected to receive at retirement from the pension plan and separately from Social Security. We concentrate on the results produced by the integrated benefit formula, not on the step-by-step process of deriving the benefit.

CONCLUSION

A pension plan integrated with Social Security is a highly efficient vehicle for delivering equitable retirement benefits. Proper design and management are essential for a successful program.

In the future, as design and financing questions arise, I would be pleased to discuss them with you.

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UNITED STATES SENATE

Committee On Governmental Affairs

Subcommittee on Civil Service, Post Office, and General Services

Paper for Policy Forum on April 17, 1984:

"OPTIONS: COORDINATING PENSIONS WITH SOCIAL SECURITY"

THE OFFSET INTEGRATION APPROACH FOR DEFINED BENEFIT PENSION PLANS

By: Manuel F. Castells
Partner
Kwasha Lipton

WHAT IS INTEGRATION?

These forums have been set up to discuss what changes should be made to the pensions of new federal employees now that they are covered under Social Security. This, the subject of my presentation today is very much at the heart of the matter. I'll be addressing the simplest of the current integration practices -- that of offsetting all or part of the Social Security benefit from the pension benefit that another plan provides. The theory of integration is fairly simple. It seeks to coordinate Social Security and other plan benefits so that, in total, they provide for a reasonable level of retirement income. This reasonable level is usually computed as a percentage of pre-retirement income. Thus integration allows for:

- (1) The level of retirement income (excluding personal savings) to be accurately planned for by the plan sponsor.
- (2) The tilt in the Social Security benefit towards the lower-paid to be compensated for so that equitable benefits are provided at all pay levels.

This presentation will explore the various integration approaches with emphasis on the offset method for defined benefit pension plans. Alternative integration approaches will be compared and contrasted, along with some discussion of other types of plans and the level of plan benefits.

CURRENT INTEGRATION PRACTICE - CORPORATE PLANS

Defined benefit plans, as the name implies, are pension plans in which the benefit at retirement is specified in some sort of formula. It is the responsibility of the plan sponsor to see that sufficient funds are available to pay for the promised retirement benefits.

Virtually all defined benefit pension plans are either directly integrated with Social Security or are implicitly integrated since benefits are lower than they might be in the absence of Social Security.

(1) The following is a brief description of the commonly used integration approaches:

- (a) Offset - This method subtracts an amount equal to some percentage of either the actual or, more commonly, the estimated Primary Social Security benefit from the gross plan formula benefit. This offset is generally pro-rated for short service employees. This is the most direct method of integration since the Social Security benefit appears explicitly in the formula. This method could produce low or even no benefits for participants at very low pay levels where the offset approaches the gross plan formula benefit.
- (b) Step-up/Excess - Under a step-up plan, benefits relate to compensation, with the benefit rate stepping-up for pay over the integration level. The integration level is related to the maximum taxable wage base for Social Security taxes. For instance, the benefit formula for a career employee might be 30% of pay up to the maximum taxable wage base for Social Security taxes plus 50% of pay in excess of such wage base. An excess plan is a special case of the step-up where the plan provides benefits only on pay over the integration level. These methods integrate in a less direct manner than the offset since the Social Security benefit never appears explicitly in the plan formula. Also, at least in the case of the step-up method, all participants will earn some benefits under the plan.
- (c) Cap - The gross plan formula benefit plus the Primary Social Security benefit is limited to some percentage of final or final average pay. This approach bears some similarities to the offset. Many plans use the cap as a maximum limit on plan benefits that are already integrated under another method.
- (d) Implicit - The level of gross plan formula benefits is lower for all participants than it would be in the absence of a Social Security program. Implicit integration is commonly found in plans that cover participants who earn similar salaries (for example, certain union plans). Integrating by simply lowering the otherwise available benefit level is especially appropriate in that situation since the Social Security benefits will be very similar for all such participants.

Currently, based on surveys of large corporate pension plans covering salaried employees, about 60% integrate by using an offset, 30% use a step-up or excess type of formula, and the remaining 10% either use a cap or are not explicitly integrated. (See Corporate Pension Plan Study - A Guide for the 80's by Banker's Life or other similar surveys)

of pension plans for details). As discussed above, the explicit integration percentages will be lower for plans covering primarily union employees. It is also widely held, though little data is available, that integration is much less prevalent among smaller plans.

(2) Legal requirements on maximum integration levels for qualified plans

Under current regulations, the maximum allowable offset for a private qualified defined benefit plan is 83-1/3% of the Primary Social Security benefit. The 83-1/3% maximum limit is derived by taking credit for the "employer's 50% share" of the Social Security benefit, adjusted for the value of ancillary Social Security benefits. (Using a similar approach, maximum integration limits are derived for step-up and excess plans.)

However, the 83-1/3% maximum offset is only applicable to a bare bones pension plan. Adjustments to the offset percentage are required for disability and survivor benefits and subsidized early retirement benefits. Therefore, for most plans, the present rules only allow an offset in the 50-60% area. These limits and adjustments as currently used are embodied in Revenue Ruling 71-446, which was issued by the Internal Revenue Service in 1971.

(3) Problems in current integration practice

Current integration rules are overly complex, particularly in regard to the adjustments that must be made to the basic integration limits. Rather than getting overly involved in the present rules, I have attached a copy of a booklet, written by Theresa B. Stuchiner, a Partner at Kwasha Lipton, entitled "How to integrate a Retirement Plan with Social Security."

Also, even if the theoretical basis underlying the rules is valid, the actual limits and adjustments developed in 1971 were based on the Social Security law then in effect. Since then many significant changes have taken place, making the current rules somewhat outdated and obsolete.

Additionally, explicitly integrated pension plan formulas result in benefits that are more difficult to calculate for the plan administrator and more difficult to understand for the plan participant. Plan participants often feel that integration is a way of taking away benefits that they have earned. Therefore, in order to avoid such misconceptions and confusion as well as to communicate the benefit program clearly, it is important that the integration be as concise and clear as possible.

Finally, there is the problem of low or no plan benefits for short service or low paid participants as well as inequities in replacement rates that can result in over or under pensioning for some plan participants.

50% OFFSET PROPOSAL

A number of proposals designed to simplify the current integration rules have been devised. One of these, the "50% offset proposal", simply has a maximum integration limit of 50% for offset plans. This limit is based on the "50% employer's share" of the Social Security benefit. (Using the same approach analogous limits are derived for step-up and excess plans). The major advantage of this proposal is that very few, if any, adjustments to the integration limit are necessary.

(1) Compatibility with current corporate practice

The 50% offset proposal ties in nicely with current integration practice since offsets for most plans are in the 50-60% range. Also, the 50% offset limit does not need to be adjusted as Social Security benefits change in the future. The limit is tied only to the employer's share of the Social Security benefit.

(2) Few adjustments to the 50% offset are needed

The 50% offset proposal requires little adjustment for ancillary benefits. Disability benefits are handled by simply offsetting 50% of the disability Social Security benefits. Also, no adjustment is needed for most death benefits. A problem arises, however, if early retirement benefits are subsidized or payable prior to age 62 (the earliest age for commencement of Social Security benefits). In this case a number of simple alternatives are available under the 50% offset proposal. These adjustments effectively reduce the amount of the offset to take account of the richer plan benefits. While this approach ties in with current integration rules for qualified plans, it may be modified or eliminated for the purpose of the CSRS plan.

A problem with the 50% offset (as with any other integration proposal that complies with current law) is that the full tilt of Social Security benefits towards the lower paid cannot be compensated for. The only alternative which accomplishes that is a full offset of the Social Security benefit.

(3) A 100% offset may be more appropriate in the absence of legislative requirements since it offsets the full Social Security tilt

For the CSRS plan, it may be advantageous to approach Social Security integration from a different point of view. Instead of looking at the employer's share of the Social Security benefit as the appropriate limit, let's construct an integration method which attempts to provide equitable benefits at all pay levels considering Social Security and the plan benefit as a unit. This approach leads to a 100% offset of the Social Security benefit as being the appropriate integration method. This method is not allowable under current integration rules for private qualified plans, but in the absence of any legal restrictions for a

government plan, it may be preferable to a lesser offset percentage. By offsetting the full Social Security tilt towards the lower paid, fair benefits at all pay levels will be provided. This method is also easy to communicate to plan participants since the integration is explicit and simple, and is being utilized in order to provide equitable benefits for all plan participants.

COMPARING OTHER INTEGRATION METHODS TO OFFSET

- (1) The step-up/excess approach has several disadvantages relative to the offset:
 - (a) Having two different rates of benefit accrual results in a plan formula that is cumbersome and difficult to understand.
 - (b) The integration limit for determining which part of a participant's pay receives the higher accrual rate should be updated each year based on the new Social Security wage base. This results in a basic plan formula that changes from one year to the next. Alternatively, if the integration limit is not adjusted annually, the plan gradually becomes less and less integrated. This occurs because the pay levels of participants are generally rising while the integration limit remains level.
 - (c) The indirect nature of Social Security integration under this method obscures the impact of the Social Security benefit on the plan benefit. In fact, the Social Security benefit is not explicitly referred to in the formula.

One advantage of the step-up/excess approach is that the benefit is easier to calculate. The Social Security integration limit is constant for all plan participants each year as compared to the offset where the Social Security benefit varies for each individual.

Also, there is no perception of earned benefits being "taken away" as can occur with the offset since nothing is being subtracted out.

- (2) The cap approach is essentially the same as the offset for final average pay plans. For other types of plans the cap, if it is to be effective for most plan participants, would make the plan appear to be a final average pay plan. But a well designed integration method should not change the basic type of plan formula. On the other hand, if the cap is not effective for many plan participants, then the plan is not really integrated.
- (3) Either implicitly integrating or not integrating has the advantage of simplicity. Also, (as was mentioned above for step-up plans) nothing is being "taken away" from the plan formula. The obvious disadvantage is the fact that the Social Security tilt towards the lower paid is not being taken into account. Therefore, these types of plans, together with Social Security, will provide benefits that are relatively higher for lower paid participants.

The exception to this, as was discussed earlier, is a plan in which the participants are all earning about the same pay. In this situation, implicit integration will be the preferred method.

FORMAL 100% OFFSET PROPOSAL

In light of the foregoing discussion, let's formulate a specific integration approach so that we may examine the problems that can arise in more detail. Our method will be a 100% offset of the Social Security benefit, with no adjustments for ancillary benefits. Employee contributions will not be required on pay below the current Social Security wage limit. The offset will be based on the appropriate Social Security benefit for that type of retirement. For example, disability retirements will have the disability Social Security benefit offset. For early retirements before age 62, no offset will be applied until age 62. The offset will be pro-rated for employees with less than full career service (i.e., 30 years).

If any adjustments are to be made for early retirements, all retirements prior to the Social Security unreduced benefit commencement age should be considered as such. This is an important point to clarify in light of the recent amendments to the Social Security laws. Under the current law, the age for commencement of unreduced Social Security benefits will rise gradually from the current age of 65 to age 67.

The Social Security benefit itself will generally be estimated on the basis of tables prepared for that purpose. Alternatively, the benefit may be the actual benefit calculated by the Social Security Administration. The latter approach is more accurate, but also more costly from an administrative point of view. Under current Social Security law, the benefit is quite complicated to calculate.

PROBLEMS WITH 100% PROPOSAL

(1) Issue of minimum benefits

As was discussed previously, the topic of minimum benefits needs to be addressed in connection with Social Security integration. Since employee contributions will be required under the CSRS plan, it may be advantageous to have a plan where all participants get some benefits at retirement. Accordingly, a minimum benefit (perhaps in the form of some flat dollar amount per month for each year of service) should probably be a part of the plan design. It is important to note that these minimum benefits are not really a part of the integration method itself. They are needed, however, in order to ensure some level of plan benefits for all participants at retirement.

(2) Ease of understanding for employees and administrators

The beauty of the 100% offset approach is its simplicity. Although the estimation of the Social Security benefit and the resulting CSRS plan benefit under this approach are not simple to calculate

and understand, the benefits provided by the two sources taken together should be well defined (by the CSRS gross plan formula) and easy to communicate. Plan participants will be able to plan financially for retirement without having to know what benefits Social Security will provide. Further, they will not have to worry about potential decreases in Social Security benefits in the future as long as the CSRS plan is there.

- (3) Possible alternatives for problem situations (short service, relatively low-paid, etc.)

In spite of the proration of the offset described above, there are still some problems for short service participants. For many, the pro rata portion of the Social Security benefit will not be a fair indicator of the amount of the benefit attributable to service with the government.

In particular, for employees with erratic pay histories and gaps in their work record, the estimated Social Security benefit used in the benefit calculation will overstate of their actual Social Security benefit and will therefore understate their pension plan benefit. This problem may be solved by using the actual Social Security benefit, although there are a number of practical problems associated with this approach. The most effective approach to this problem as well as the problem, of low or no benefits for lower paid employees, might be to install minimum benefits.

DEFINED CONTRIBUTION PLANS

A defined contribution plan (e.g. savings plan) does not specify a benefit at retirement. The benefit is simply the equal to the amount of money in the participant's account. No benefit level is guaranteed. Therefore, a defined contribution plan is always fully funded. Currently, many corporations are making use of defined contribution plans in their retirement programs. Most of these plans are not integrated with Social Security -- that is, the contribution rates are the same at all pay levels. Due to the less stable and unpredictable nature of the defined contribution plan benefit, this type of plan is generally used to supplement a defined benefit pension plan. The defined benefit plan is generally integrated and forms the major part of the retirement income program. We anticipate that, if the CSRS retirement program incorporates a defined contribution plan, it will be used in a similar manner and therefore integration will probably not be an issue.

LEVEL OF PLAN BENEFITS

Finally, a few words should be said about the level of benefits to be provided by the combination of the CSRS plan and the Social Security benefit.

Generally, in the corporate world, a post retirement income objective is defined. The sources usually considered are (1) pension benefits, (2) Social Security, and (3) personal savings. A common objective is

to provide the same level of pre-retirement income to the full career participant after retirement at or after age 65 on a post-tax basis. This approach is probably advisable for the CSRS plan as well. Integrating the CSRS benefit fully with Social Security greatly simplifies the analysis of retirement income objectives and total benefits will be unaffected by future changes in the level of Social Security benefits. Of course if Social Security benefits were to decrease in the future, the slack would be made up by the CSRS pension plan and the cost of the plan would rise accordingly. Therefore, it is important to follow up the initial retirement income objective at reasonable intervals throughout the life of the plan so that the level of plan benefits may be re-evaluated in light of changing circumstances.

**Social Security: Historical Development and
Current Structure, Benefits and Contributions**

**Prepared for the Policy Forum on Federal Retirement
Sponsored by the Senate Committee on Government Affairs
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**Any views expressed are the author's own and not necessarily
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I. INTRODUCTION

This paper describes the key elements of the U.S. Social Security system. The first section traces the development of that system from its beginnings in the 1930's through the most recent major modification in 1983. The next section outlines the major features of the system today. The final section discusses the current projections of the future financial condition of the program.

II. DEVELOPMENT OF THE PUBLIC RETIREMENT INCOME PROGRAM

A. The Social Security Act of 1935

The prevailing social ethic in the United States has traditionally placed a high value on self-reliance and self-provision, and this may help explain why the United States was one of the last major industrial countries to adopt a program of public social insurance. Social Security is the product of the Great Depression, the period in our history during which the ethic of self-reliance faced its most serious challenge. Yet the program's design reflects the continuing desire to preserve and reinforce the work ethic.

Prior to the Depression, the federal government role in retirement income security consisted almost exclusively of providing pensions for its own employees--mostly postal workers--and for veterans of the Armed Forces. The primary public sector role in caring for the needy aged was played by local governments and to some extent state governments, and traditionally this role was discharged through the operation of alms-houses and poor farms. Beginning in 1915, individual states began adopting programs offering cash assistance to needy aged residents. By 1930, of the 50 jurisdictions that are now states, 18 had some program of cash assistance for the needy aged; by 1935, 31 States had such a program.

During the Depression, millions lost their jobs and were forced to use savings accumulated for future retirement instead for support of their families. Others saw their personal savings disappear as a result of bank and business failures. The number of people who needed the assistance of others in order to survive grew enormously, and many who had never before thought they would ever need or accept government assistance found that they had no alternative. The political climate changed abruptly as the number in need of assistance greatly exceeded the ability of traditional state and local government institutions or of private charities and individual families to supply the assistance.

The federal government responded first with loans and then with grants to state governments to help these governments defray the cost of assisting the needy. When these efforts proved inadequate, direct federal emergency relief programs were established. Nonetheless, by 1937 the government estimated that roughly half of the population over age 65 had essentially no independent means of support at all and were dependent entirely on their friends, relatives, and children.

In this environment considerable political pressure developed for the enactment of more permanent measures to assure economic security, especially for the aged, and to further relieve the fiscal burden on state and local governments. A number of fairly radical proposals began to gain substantial support across the country, and the response of President Roosevelt and the Congress was the Social Security Act of 1935¹. This Act created a variety of new economic security programs.² Among the most important were two of the basic elements of the present retirement income security system in the United States:

- (1) A national program of needs-based benefits for the aged.
- (2) The Old-Age Insurance program that is the cornerstone of today's Social Security program.

The needs-based program, called Old-Age Assistance, was viewed as the federal response to the immediate problem of income support for the needy aged. The precursor of today's SSI program, it was built on the pre-existing state programs. Under Old-Age Assistance, the federal government offered to finance one-half of the cost incurred by each state in operating a program of cash assistance for the needy aged. To be eligible for

¹Perhaps the most popular of the alternative proposals was the so-called Townsend Plan, which, it was argued, would both help the aged and cure the Depression. Under this plan, all citizens over 60 would be given a cash grant of \$200 a month regardless of their financial circumstances. The only condition for receipt of the grant would be that the full amount be spent within one month. (At the time, \$200 a month was almost twice the amount earned in a month by the average worker.) Proponents of the plan proposed that it be financed by a 2-percent national transaction tax. The plan had considerable political support despite the fact that public finance experts could never figure out how a 2-percent transaction tax would raise nearly enough money to finance the proposed expenditures.

²The act also created the Unemployment Insurance and Aid to Dependent Children programs.

federal sharing of the cost, a state program had to meet certain specified conditions, perhaps the most important of which was that eligibility be offered to all needy residents over the age of 65. Other elements were left to state option, including decisions about the level of benefits to be paid in each state program. At the outset, the federal government's only restriction on benefit levels was that federal payments not amount to more than \$15 per month per case.

The social insurance program, initially called Old-Age Annuities and subsequently called Old-Age Insurance, was viewed not as a solution to the immediate problem, but as the response to the longer-range retirement income needs of the nation's aged. Under the program as it was enacted in 1935, no benefits would be paid at all until 1942. Monthly benefits were to be based on a worker's accumulated taxable earnings. Moreover, monthly benefits paid to the first retirement cohorts would have been fairly modest because persons reaching retirement age in the 1940s would not have worked under the Social Security program for a very long period of time, and therefore, would not have had the chance to accumulate substantial amounts of taxable earnings. Indeed, under the program as enacted in 1935, the maximum anticipated benefit levels would have been reached only for those workers reaching 65 in 1982.

One important feature of the 1935 Act was the method chosen to finance Old-Age Insurance. The 1935 Act provided that benefits would be financed entirely from a payroll tax with one-half of the tax to be levied on the employer and the other half to be collected from the workers in the form of deductions from their pay checks. Specifically, there was to be no government contribution from the general revenues. The exclusive reliance on payroll tax finance was a conscious decision made by President Roosevelt and the Congress against the advice of many of those who had worked to develop the various economic security programs contained in the Social Security Act. Apparently the President and the Congress felt that in a society which placed a high value on self-reliance and self-provision it was appropriate for workers and their employers to bear the entire cost of retirement benefits through their tax-contributions.

Another important feature of the 1935 Act was the structure selected for the benefit package. Social insurance programs must strike a balance between the conflicting objectives of "individual equity" and "social adequacy." In some countries (e.g. West Germany) retirement benefits are scaled fairly directly to the worker's preretirement earnings level. The monthly benefit paid to a higher-wage worker exceeds that paid to a lower wage worker by roughly the same proportion that the higher-wage earner's preretirement earnings had exceeded those of the lower-wage earner. This kind of benefit structure is said to

stress the individual equity objective in that benefits are roughly proportional to preretirement earnings and hence to the level of the worker's past social insurance contributions.³ On the other hand, in other countries (e.g. The Netherlands) Social Security pays flat-rate benefits. In these systems each worker receives upon retirement the same monthly benefit (perhaps scaled for years over which contributions had been made) regardless of the level of his or her preretirement earnings. This structure is said to stress the social adequacy goal of assuring at least a minimum level of retirement income.

Most countries structure their social security programs to strike a balance between these two objectives, and the striking of such a balance has been the policy in the U.S. from the beginning. Social Security in the United States always contained elements of individual equity in that higher-wage workers would receive at retirement larger monthly benefits than were received by lower-wage workers. It also had elements of social adequacy, however, in that the ratio of the benefit received by a low-wage earner to that earner's preretirement earnings exceeded the ratio of the benefit received by a higher-wage earner to the higher earner's preretirement earnings. In other words Social Security would "replace" a greater fraction of the preretirement earnings of the low earner than of the higher-wage earner. Under the 1935 Act, when the system was fully mature, retirement benefits for an earner with wages at the maximum amount taxable would represent only 34 percent of preretirement earnings; benefits for an average earner would represent 58 percent of the worker's preretirement earnings level; and benefits for a worker whose earnings averaged only half of those of the average earner would replace 73 percent of preretirement earnings.

B. Subsequent Development of Public Income Programs

The public income security programs created in 1935 have been modified and extended repeatedly in the years since. Some of these changes represented extensions envisioned in 1935, but for one reason or another not enacted then. Others represented modifications to the basic provisions of the original Social Security Act. To a surprising degree, however, many of the basic

³The West German system does have several significant features that reflect social adequacy concerns, however. These include special earnings credits for long-service, low wage workers and benefits for widows and widowers.

elements of the public income security programs today are largely the same as they were when the programs were established almost 50 years ago.

Perhaps the most substantial modification to the structure of Social Security occurred in 1939, just four years after the program was created and before its first benefits were paid. There were two major changes. First, the benefit computation procedures were restructured so that benefits payable to workers retiring in the early years of the program--the 1940's and 1950's--were increased, while benefits scheduled for workers reaching retirement age when the program was fully mature--in the 1970's and 1980's--were reduced. Secondly, benefits for single retirees were reduced and monthly benefits were added for the dependents of retired workers and for the widows and children of workers dying before they reached retirement age. The program became Old-Age and Survivors Insurance.

The 1939 reshuffling of the benefit package had virtually no effect on average projected costs over the 40-year period from 1940 through 1980. The extra cost of monthly benefits to dependents of retired workers and survivors of deceased workers was offset by the savings produced by reducing benefits for single workers. The higher costs for benefit payments in the 1940's was offset by lower annual costs for benefit payments in the 1970's and 1980's. However, both changes had the effect of increasing the relative importance of social adequacy concerns at the expense of individual equity concerns in the Social Security benefit structure.

In the original Social Security Act, coverage was limited to wage and salary employees in private sector commercial and industrial enterprises. Federal government and railroad employees as well as State and local government employees were excluded. The former already had an adequate pension program sponsored by the federal government. The latter were excluded on the grounds that the federal government could not require participation because (it was then widely felt) the Constitution of the United States did not empower the federal government to levy a tax on state governments. Self-employed individuals (including farmers and professionals) and farm and domestic workers also were excluded, at least in part because of a fear that it would be very difficult to administer equitably a payroll tax levied on these workers.

Several amendments in the 1950's substantially reduced the number of American workers not covered by the Old-Age and Survivor's Insurance program. Mandatory coverage was extended to most self-employed individuals, to farm and domestic workers, and to members of the Armed Forces, while private nonprofit employers and state and local governments were given the option of electing

to be covered by Social Security. Over the years, the Railroad Retirement program has been modified so that today its basic benefits and financing arrangements so closely resemble Social Security that it operates almost as if railroad workers were covered directly by Social Security. Finally, in 1983 mandatory coverage was extended to all civilian employees of the federal government hired after 1983 and to all employees of nonprofit establishments. In addition, those state and local governments which had elected coverage earlier were prohibited from terminating.

The two major expansions in the scope of the Social Security program have been the addition of disability insurance in 1956 and of Medicare in 1965. Both of these additions had been identifiable by the program's early architects and advocates as desirable future additions to the benefit package, but they proved to be more controversial than the program of cash benefits for the aged. Each was adopted only after extended debate in the Congress and across the country, and each was established with its own identifiable portion of the Social Security payroll tax and its own separate trust fund. Initially, disability benefits were paid only to workers who were over age 50. However, in 1958 benefits were extended to those dependents of disabled workers that would qualify for benefits if they were dependents of retired workers, and in 1960 eligibility was extended to workers under age 50. Initially, Medicare was only available to those 65 and older; in 1972 it was extended to cover most disabled workers as well.

Although the cash benefit package has been modified repeatedly by the Congress in the years since 1939, there have been few changes in its basic structure. Among the more important modifications were:

- (1) the addition (in 1956 for women and 1961 for men) of actuarially reduced benefits for workers aged 62 to 65;
- (2) increases (in 1956, 1972, and, with more limited applicability, 1983) in the monthly benefit paid to surviving widows and widowers;
- (3) the addition (in 1965) and subsequent liberalization (in 1972, 1977, and 1983) of benefits for divorced women (and, beginning in the late 1970s, men);
- (4) the addition (in 1965) and subsequent repeal (in 1981) of benefits for students aged 18 through 21; and

- (5) the freezing (in 1977) and subsequent repeal (in 1981) of the minimum benefit.

Average benefit levels have been adjusted repeatedly to keep them more or less in line with changes in prevailing wage and price levels. In general, these adjustments were insufficient to keep up with wage and price changes in the 1940's but exceeded wage and price increases from the mid 1960s through 1972. Increasing awareness of the need to adjust the program for changes in nominal wage and price levels eventually lead to automatic indexing. Legislation enacted in 1972 indexed benefits automatically to the consumer price index, and the current procedure for calculating initial benefit amounts and for indexing that calculation was adopted in 1977.

In addition to the means-tested program of Old-Age Assistance, the Social Security Act of 1935 authorized federal grants to states to pay part of the costs of cash assistance to needy blind people. In 1950, another program was added which provided federal grants to defray partially the costs of state assistance to the needy who were permanently and totally disabled. In 1974, the structure of these cash assistance programs changed considerably, when the older programs of federal grants to states were replaced by the federal Supplemental Security Income Program (SSI). The SSI program guarantees a nationally-uniform, federal-financed minimum income to all needy aged, blind and disabled. Under this program, however, state governments are given the option of providing their residents with higher benefits than are provided under the federal program. Since many states do supplement the federal SSI payment, benefit levels continue to vary from state to state.

Despite the increased federal role in providing means-tested assistance, the importance of this type of aid has declined over the years while the size of the insurance program has grown significantly as it has matured. These trends are illustrated in Table 1, which shows the number of aged persons receiving Social Security and/or public assistance per 1,000 aged persons in the U.S. population. In 1940, 7 out of 1,000 aged persons were receiving Social Security benefits, while 217 out of 1,000 received Old-Age Assistance. By 1980, 914 out of 1,000 aged persons were receiving Social Security, while only 87 were receiving SSI.

Table 1

Persons 65 or Older Receiving Social Security and/or
Means-Tested Assistance, 1940-1980

Aged Recipients Per 1,000 Aged Persons				
Year	OASI	OAA or SSI	OASI and SSI	OASI and/or SSI
1940	7	217	1	223
1950	164	224	22	366
1960	616	141	41	716
1970	855	104	63	896
1980	914	87	61	941

Source: Social Security Bulletin, Annual Statistical
Supplement, 1982, Table 167

III. The Old-Age, Survivors, and Disability Insurance (OASDI) Program

A. Description of the Program

The essential elements of the Social Security program are that it:

1. Is contributory, in that it is financed virtually exclusively by worker and employer contributions in the form of payroll taxes.
2. Pays an earnings related benefit, the size of which depends on, but is not directly proportional to, the earnings upon which prior contributions were made.
3. Is designed to replace only a portion of pre-retirement (or disability) earnings, especially for workers with earnings at or above average.
4. Is designed to encourage supplementation of benefits through private pensions and savings by paying benefits without a test of individual need.

Eligibility. To be eligible for retirement benefits a worker must have worked a minimum amount of time in employment that is covered by the program (and, hence, subject to the Social Security payroll tax). Workers reaching retirement age after 1990 must have worked the equivalent of 10 years in covered employment to qualify for benefits. Those reaching retirement age today must have worked at least one-quarter of the time between 1950 and the year they turn 62.⁴

More than 90 percent of the wage and salary workers and self-employed individuals in the United States are in employment covered by Social Security. The vast majority are in jobs for which coverage is mandated by law. Coverage is not mandated, but may be elected, for employees of state and local governments; under the 1983 legislation, once coverage has been elected it can not be terminated. About 70 percent of the employees of state and local governments are covered by Social Security. Prior to 1984, civilian employees of the federal government were not covered, but all such persons hired after 1983 are covered.⁵

⁴A worker turning 62 in 1984 must have spent 8 and 1/4 years in covered employment to be eligible for retirement benefits. If a worker has sufficient attachment to covered employment to be eligible for--technically, "insured" for--retirement benefits, that worker also has sufficient credits to qualify his (or her) survivors for benefits in the event the worker dies. Those workers who die before they reach retirement age are insured for survivor benefits if they have been in covered employment for at least one-quarter of the years elapsing between the year they turned 21 (or 1950, if they turned 21 before 1950) and the year they died. To be insured for disability benefits, a worker must: (1) be insured for survivor benefits in the manner just outlined and, in addition, (2) have worked at least 5 or the previous 10 years in covered employment. Disabled workers under age 31 have to meet an alternative rule, and no one is ever insured for survivor or disability benefits without at least one and one-half years in covered employment.

⁵Technically, persons employed by railroads are covered by their own retirement program instead of Social Security. However, the railroad retirement and Social Security programs are so closely coordinated that for virtually all intents and purposes, railroad workers are covered by Social Security.

Computing the Basic Benefit⁶ Social Security benefits are based on the worker's career average taxable earnings. When a worker files for retirement the worker's taxable earnings for each year since 1950 are adjusted to reflect the increase in economy wide earnings levels occurring since the year the earnings were actually received.⁷

A few of the years in which indexed earnings were the lowest are dropped, and the figures that remain are averaged to produce the worker's average indexed monthly earnings or AIME.⁸ For

⁶The computation described here is the regular procedure applicable to persons turning 62, dying, or becoming disabled after 1979. A different (though comparable) procedure was in general use prior to 1979. There is also an "old-start" method which uses earnings credits back to 1937, but which is now rarely used because it usually produces a lower benefit. Finally, a special transitional guarantee which is similar to the method used previously can be used by people who reach 62 between 1979 and 1983.

⁷Technically, the earnings are indexed to the level prevailing the year the worker turned 60. For workers who die or become disabled before reaching age 62, earnings are indexed to the level two years before the date of death or disability. The two-year lag occurs because the measure used to construct the index first becomes available about ten months after the close of the year to which it applies. Retired workers' earnings are indexed to the level prevailing the year they turn 60 because workers are first eligible for benefits at age 62.

⁸In computing their AIME, workers must use as many years of indexed earnings as there are years elapsing between 1955 and the year the worker turns 62. A worker turning 62 in 1984 averages over the highest 28 years. Workers may use earnings from any year after 1950 in the calculation. If the worker turning 62 in 1984 retires at age 62, there will be 33 annual earnings figures (starting with 1951 and ending with 1983) in his earnings record. In effect, the worker gets to drop the lowest 5 from the calculation. Earnings in the year the worker reaches age 62 and later years may be substituted, without indexing, for lower indexed earnings in earlier years. Thus, if the worker continues to work until age 68 (in 1990), the worker will have 39 annual earnings figures in his earnings record and can drop the lowest 11. Workers who die before reaching age 62 average over the number of years equal to the number elapsing between 1955 and the year of death. The averaging period for older disabled workers is the same as that for workers who die before age 62. The rules for younger disabled workers (those becoming disabled before age 47) are more complicated.

workers reaching retirement age after 1990, AIME's will be computed over the highest 35 years of earnings. The use of a career average introduces some recognition of length of service into the calculation: If a worker does not have as many years of earnings as are required by the calculation, one or more years with zero earnings must be used.

The building block upon which all benefit amounts are based is called the primary insurance amount, or PIA. It is the benefit paid to a worker retiring at the normal retirement age, currently age 65. The PIA is calculated by applying a three-bracket "benefit formula" to the AIME. For workers dying, becoming disabled, or reaching 62 in 1984, the primary insurance amount is:

- 90 percent of the first \$267 of AIME, plus
- 32 percent of the next \$1,345 of AIME, plus
- 15 percent of the remainder,

with the result increased by the amount of any general benefit increases, such as cost of living adjustments, after 1984.

Each year, the bracket boundaries in the benefit formula are increased (or, if appropriate, decreased) by the percentage change in average wages in the economy. This produces the benefit formula applicable for workers dying, becoming disabled, or reaching 62 in the subsequent year. The adjustment has the effect of increasing the average initial retirement benefit awarded to successive cohorts at roughly the same rate as average money wage levels are increasing.

Adjustments for Age First Drawn. Monthly benefits are permanently increased or decreased if first drawn after or before age 65. Benefits are reduced by 6-2/3 percent for each full year before age 65 that they are first drawn. A worker's benefit at age 62, the age at which retirement benefits are first payable, thus amounts to about 80 percent of the primary insurance amount. Benefits are increased by 3 percent for each year after age 65 (up to age 70) that payment is delayed. A worker first claiming benefits at age 70 therefore receives a monthly benefit equal to 115 percent of the PIA.

The 1983 legislation scheduled future adjustments in the normal retirement age and the adjustments for early and delayed retirement. An increase in the credit for delaying retirement will be phased in beginning with the cohort turning 62 in 1987. Their benefits will be increased by 3-1/2 percent per year for each year that benefit receipt is delayed after the normal retirement age. The credit is increased by one-half percentage

point for every other cohort until it reaches 8 percent per year for those turning 62 after 2004. In addition, the normal retirement age is scheduled to increase by 2 years beginning in the year 2000. It will rise from 65 to 66 in the first decade after the year 2000 and from 66 to 67 in the third decade of the 21st century.⁹ Early retirement benefits will still be available at age 62 after the retirement age increases, but they will be further reduced relative to the primary insurance amount. When the normal retirement age is age 67 workers retiring at age 62 will receive 70 percent of their PIA rather than 80 percent.

Dependents' Benefits. Monthly Social Security benefits are also available for certain spouses and for minor children of workers receiving retirement benefits. In theory, each child under age 18 receives a benefit equal to 50 percent of the PIA; a spouse caring for such a child under age 16 can receive a benefit equal to 50 percent of the PIA, and a spouse age 65 or over when benefits are first claimed also gets 50 percent.¹⁰ In practice, a maximum limits the amount payable on the basis of any single earnings record. The maximum is about 150 percent of the primary insurance amount at lower earnings levels and about 175 percent of the PIA at higher levels.¹¹ Thus, a retired worker and his wife would receive 150 percent of the worker's PIA, while a worker with a wife and one child would receive the maximum benefit payable based on the worker's earnings, which is less than 200 percent of the worker's PIA.

⁹Under current law, the normal retirement age is 65 for workers born in or before 1937; it increases by 2 months for each birth cohort beginning with the 1938 birth cohort and ending with the 1943 birth cohort. It is 66 for those born between 1943 and 1954, but again increases by 2 months for each birth cohort beginning with the 1955 birth cohort and ending with the 1960 birth cohort. It is age 67 for all workers born after 1960. The normal retirement age for widows born in any given year is equal to the normal retirement age for workers born 2 years previously.

¹⁰Spouses' benefits can be claimed as early as age 62 even if there are no minor children. However, they are permanently reduced by 25/36 percent for each month by which the spouse is under age 65.

¹¹The maximum family benefits actually varies from 150 percent of the PIA at low PIA levels to 188 percent of the PIA at the middle level and drops to 175 percent at relatively high PIA levels. This variation is largely the result of historical accident.

Disabled workers receive a monthly benefit equal to their PIA regardless of their age. Their dependents are entitled to benefits under the same circumstances and in the same amounts as the dependents of retired workers. However, the limit on benefits for disabled workers' families is somewhat lower than for retired workers with the same PIA.

Aged widows (and widowers) of insured workers are eligible for a benefit equal to the worker's PIA if they first draw the benefit at the normal retirement age.¹² If either they (or their deceased spouses) draw a benefit before the normal retirement age, the widow(er)s benefit is permanently reduced. The benefit can be drawn as early as age 60, but if drawn at age 60, is equal to 71.5 percent of the PIA. Monthly benefits are also payable to the minor children of deceased workers and (if there is a child under age 16 receiving benefits) to a surviving spouse, regardless of age. Each receives 75 percent of the PIA subject to the limits imposed by the family maximum provision.

It is not uncommon for one person to be entitled potentially to more than one benefit at a given time--as, say, a retired worker and as the spouse or widow of a retired worker. Those people are said to be "dually entitled" and are paid an amount equal to the higher benefit for which they qualify.

Earnings Test. Social Security beneficiaries will have all or some of their benefits withheld if their earnings in a given year exceed a certain "exempt amount." In 1984, the exempt amount is \$5,160 for beneficiaries under age 65, and \$6,960 for those age 65 and over. Full benefits are paid as long as annual earnings are below these amounts; but if earnings exceed these levels, \$1 in benefits is withheld for each \$2 by which earnings exceed the exempt amount.¹³ The exempt amounts are increased automatically each year by the percentage increase in average wage levels.

Cost-of-Living Adjustments. Post-entitlement benefit levels are adjusted automatically to reflect increases in the cost of living as measured by a national consumer price index (CPI). The average value of the index in the third calendar quarter of the year is compared to its value at the time the last automatic

¹²If a worker dies before reaching age 62, the widow(er) is not disabled, and the widow(er) is under 60 when the worker dies, the worker's PIA is adjusted to reflect increases in average wage levels occurring after the worker died.

¹³Beginning in 1990, \$1 of benefits will be withheld for every \$3 in excess earnings beginning with the year the beneficiary attains the normal retirement age.

increases was triggered.¹⁴ If the measure has increased by at least 3 percent, all monthly benefits are increased by the same percentage amount as the CPI index has increased. The increase is effective with the January checks. The size of the cost-of-living increase is constrained not to exceed the increase in average wages occurring in the calendar year preceding the time at which this calculation is being made if the wage increase is less than the CPI increase and the program's financial reserves are very low.¹⁵

B. Structure of Benefits

As noted, the Social Security benefit formula is structured to provide higher benefits to the worker with higher average career earnings, but to provide the worker with the lower AIME's a benefit that represents a higher fraction of the worker's pre-retirement earnings average. The formula thus is weighted to favor those with lower average earnings. The weighting is usually justified on the grounds that higher paid workers are more likely to have (or alternatively should be expected or encouraged to have) substantial income from other sources, such as employer pensions and individual savings and investments, to supplement Social Security benefits.

The practical effect of the structure is illustrated in the table below which compares hypothetical replacement rates at different current earnings levels. The comparison focuses on three workers, one whose earnings were always at the level of full-time work at the minimum wage level allowed by Federal law, one whose earnings have always been equal to the average for all workers under Social Security, and one who has always earned the maximum amount that is taxed and credited for benefit purposes. The table shows the 1983 earnings level for each and the ultimate replacement rate afforded each by the current Social Security

¹⁴But no earlier than the third quarter of 1982.

¹⁵"Very low" means trust fund assets are projected to be less than 15 percent of of next year's projected annual expenditures at the end of any year from 1984 through 1988, and are projected to be less than 20 percent of projected annual expenditures at the end of any year thereafter. The calculation focuses on total reserves and total expenditures in Old-Age, Survivors' and Disability Insurance.

law. (The replacement rate shown here is the benefit for a worker retiring at the normal retirement age as a percentage of the earnings in the year before retirement.)¹⁶

Table 2

Social Security Replacement Rates
For Hypothetical Workers

Worker	1983 Earnings Level	Ultimate Replacement Rate
Minimum	\$ 6,968	55.1%
Average	15,201	41.3%
Maximum	35,700	27.7%

Source: Social Security Administration, Office of the Actuary.

The replacement rates in Table 2 are for hypothetical, full career workers. In the late 1960s the Social Security Administration began a longitudinal survey which followed a cohort of actual workers as they entered retirement and began to receive Social Security and other retirement benefits. The data in Tables 3 and 4, taken from that survey, reflect replacement rates based on actual benefits received by and the actual earnings of this sample cohort of workers. (The cohort retired in the early 1970s; the calculation uses 1976 benefits and preretirement earnings at 1976 levels.)

¹⁶Because of some complexities arising from the introduction of the new computational system described here, people retiring at age 65 in the next several years will actually have somewhat higher replacement rates than those shown here. Also, because age-65 replacement rates will reflect actual cost-of-living adjustments for the 3 prior years, some year-to-year fluctuation in these rates can be anticipated over the long range. This calculation implicitly assumes that the federal minimum wage grows in the future at the same rate that average wages grow, although nothing in the law guarantees such a result.

Table 3

The Social Security Replacement Rates
For a Sample of Actual Workers

Replacement Rate Quartile	Primary Insurance Amount			Monthly Benefit Amount		
	Married Men	Nonmarried Men	Women	Married Men	Nonmarried Men	Women
First	35	36	43	34	34	40
Median	40	43	48	38	40	46
Third	47	52	57	46	49	54

¹Preretirement earnings are defined as the average of the middle four years from the ten years immediately preceding retirement (the high 3 and low 3 years are dropped). Earnings above the taxable maximum are ignored.

Source: Alan Fox (1982), Table 2. For details of sample selection and size, see the original article.

As shown in Table 3, the primary insurance amount for the median married man in the survey represented 40 percent of his Social Security covered preretirement earnings, and the monthly benefit was 38 percent of preretirement covered earnings. One-fourth of the married men (generally those with the lowest average earnings) had replacement rates of 47 percent or more, and one-fourth (generally those with the highest average earnings) had replacement rates of 35 percent or less. Replacement rates for nonmarried men and nonmarried women were somewhat higher because their preretirement earnings were somewhat lower.

As discussed previously, Social Security replacement rates for average and above average earners have been set at lower levels in part on the assumption that higher earners would have supplemental, private retirement incomes. The major source of private retirement income is employer-provided pensions. The data in Table 4 are from the same longitudinal survey that produced the data in Table 3 and illustrate how Social Security benefits and private pension benefits interact.

Table 4
1976 Social Security and Second Pension Replacement Rates
For a Sample of Actual Married Couples

Preretirement Earnings ²	Replacement Rate ¹		
	Percent Receiving Second Pensions	Social Security Only	Total
1st Quintile (under \$6,891)	9%	76%	79%
2nd Quintile (\$6,891 to \$10,799)	35	55	60%
3rd Quintile (\$10,800 to \$13,765)	57	45	57%
4th Quintile (\$13,766 to \$18,026)	69	37	50%
5th Quintile (over \$18,027)	76	28	46%

1. Benefits in 1976 prices divided by average earnings.
2. Combined average preretirement earnings of husband and wife, including estimate of earnings above the Social Security maximum. Average constructed by indexing all earnings to levels prevailing in 1976, dropping lowest 3 and highest 3 years in the ten years prior to retirement, and averaging the remaining 4 years.

Source: Fox (1982), Table 8. Data based on a sample of 1,859 cases. For further details, see source.

Table 4 focuses only on married couples. In constructing the replacement rates in this table, the couple's combined monthly benefits from both Social Security and private pensions are compared to estimates of the combined total preretirement earnings of husband and wife. As expected, the Social Security replacement rate declines as preretirement earnings levels rise. However, the incidence of private pension receipt rises as preretirement earnings levels rise, and the increasing prevalence of private pensions at higher earnings levels serves, as was intended, to offset partially the reduction in Social Security replacement rates.

C. Financing

For the cash benefit programs and the hospital insurance part of medicare, the vast majority (usually over 95 percent) of the necessary revenues are derived from the Social Security payroll tax. This tax is a flat rate tax levied at equal rates on employers and employees and applied to all earnings up to a specified annual maximum; in 1984, \$37,800. The taxable maximum is indexed to rise at the rate average wage levels are rising and is adjusted each time a cost-of-living increase occurs; the maximum sets a ceiling on both the amount of earnings that can be taxed and the amount that can be credited for benefit computation purposes in any given year. At the current level of the taxable maximum, about 90 percent of all earnings derived from employment covered by the program are taxable and about 94 percent of the people who work in covered employment are taxed on their entire annual earnings.

The proceeds of the payroll tax, along with any other revenues used to support the program, are deposited in special Treasury accounts--the trust funds--and all benefit payments and administrative expenses are charged to these accounts. There are separate accounts for Old-Age and Survivors' Insurance (OASI), Disability Insurance (DI) and each of the two parts of the Medicare program. Hospital Insurance (HI), which is Part A of Medicare, is financed almost entirely from payroll taxes in much the same way as are the cash benefit programs: Supplementary Medical Insurance (SMI), which is Part B of Medicare, is financed from participant's premiums and the general revenues.

The law specifies both the aggregate payroll tax rate and the manner in which payroll tax revenues are to be divided among the three payroll tax-financed programs. Currently scheduled tax rates for either employees or employers are shown in Table 5. Since employees and employers each pay the rate shown in Table 5, the combined cost in 1985 is two times 7.05 percent, or 14.1 percent of taxable payroll. Also, in 1984 there is a one-time general revenue financed tax credit for employees equal to 0.3 percent of taxable wages. In principle, the employee will be paying 7.0 percent into the Social Security Trust funds as shown above. But in practice, the employees' liability is immediately reduced to 6.7 percent of taxable pay because of the one-time tax credit. Employees will have the full 7.05 percent tax deducted in 1985.

In the past, Social Security benefits were exempt from federal income taxes. Beginning in 1984, however, a portion of Social Security cash benefits may be counted as income for purposes of computing federal personal income tax liabilities. Benefits remain tax free for single taxpayers with incomes of less than \$25,000 and married couples filing jointly with incomes

of less than \$32,000.¹⁷ Taxpayer units with incomes in excess of these limits (as well as all married couples filing separate returns) must include up to one-half of their Social Security benefits as taxable income. Amounts equivalent to the estimated quarterly proceeds from taxing benefits are deposited in the Social Security trust funds. These revenues are projected to amount to just over \$2.5 billion in calendar 1984, and should constitute the second largest source of revenue for the cash benefit program in that year.

Table 5

Currently Scheduled Social Security Payroll Tax Rates

Year	OASI	DI	OASDI	HI	OASDHI
1984	5.2%	0.5%	5.7%	1.3%	7.0%
1985	5.2	.5	5.7	1.35	7.05
1986-87	5.2	.5	5.7	1.45	7.15
1988-89	5.53	.53	6.06	1.45	7.51
1990-99	5.60	.6	6.20	1.45	7.65
2000 and later	5.49	.71	6.20	1.45	7.65

Source: John Svahn and Mary Ross (1983), Table A

¹⁷For the purpose of this calculation, income is defined as adjusted gross income plus one-half of the Social Security benefit received plus certain other sources of income that are otherwise exempt from federal income taxes. The income limits are not indexed.

III. Current Financial Projections

Social Security is financed on a current cost basis. This means that most of the revenues collected in any given year are used to finance the benefits paid that year. Traditionally, the balances in the trust funds have been viewed as contingency reserves whose primary purpose is to cushion temporary imbalances between income and outgo.

An annual report of the trust funds' board of trustees is submitted to the Congress each spring showing detailed projections of costs and revenues for 75 years into the future. The projections are made under three or four different sets of assumptions about key future demographic and economic developments. Additional projections of short-range financial performance are prepared at other times during the year.

The data in Table 6 are from the most recent short-range estimates of the status of the Social Security cash benefit program. These projections are based on the economic assumptions used for the 1984 Trustees' Report.

They suggest that the balance between revenues and expenditures will be very close between now and the end of 1987, although income is projected to exceed outgo in each of the years. The financial condition is projected to improve dramatically beginning in 1988, largely as a result of the higher OASDI tax rate which goes into effect that year. Under these projections, the final portion of the loan from HI is paid off during 1987, and the program experiences substantial surpluses into the 1990's.

Longer-range projections from the 1984 report of the Board of Trustees are summarized in Table 7. These projections express future costs and future income as a percentage of total earnings subject to the payroll tax; the projections employ a pessimistic set of assumptions, an optimistic assumption set, and an intermediate set.

The 75-year projections under the intermediate assumption set are shown at the top and center of Table 7. Costs are projected to average 12.95 percent of taxable payroll, average total revenues are projected to be 12.90 percent of payroll, and the two are essentially balanced.

Not surprisingly, the full picture is not quite as simple as this one 75-year result implies, and some of the complexities are illustrated in the rest of Table 7. For example, the other results at the top of the table show the sensitivity of the cost projections to the demographic and economic assumptions

Table 6.

Estimated Operations of the OASDI Trust Funds Combined Under Present Law
on the Basis of the 1984 Trustee Report, (Intermediate (B) Assumptions),
Calendar Years 1983-93 (Amounts in billions)

Calendar Year	Income	Outgo	Interfund Transfers ¹	Net Change	Funds at End of Year ²	Reserv. Ratio
1983.	\$171.3	\$171.2		\$ 0.1	\$ 24.9	14%
1984	184.4	181.5		2.9	27.7	21%
1985	203.2	194.1		9.1	36.8	21%
1986	221.6	209.3	\$ -5.5	6.7	43.6	25%
1987	241.2	226.2	-6.9	8.1	51.7	27%
1988	277.2	243.4		33.8	85.4	29%
1989	301.2	260.3		41.0	126.4	41%
1990	331.8	277.6		54.3	180.7	54%
1991	356.9	295.1		61.8	242.5	69%
1992	382.5	313.5		69.0	311.5	85%
1993	410.4	332.8		77.6	389.1	101%

¹Transfers to HI Trust Fund to repay earlier loans (Transfers between OASI and DI are netted out).

²For 1983-85, includes \$12.4 billion outstanding loan from HI. Projections show loan being repaid in 1986-87 time frame.

³Assets at beginning of year as percentage of outgo during year. Assets include the advance tax transfer for January.

Source: Social Security Administration, Office of the Actuary, Memorandum on Estimated Operations of the OASI, DI, and HI Trust Funds on the Basis of the 1984 Trustees Report Assumptions, April 5, 1984, table 4.

employed. Over the next 75 years, the system could be under-financed by an average 4.1 percent of payroll or could be over-financed by almost 3 percent of payroll if one wishes to employ, alternatively, plausible pessimistic assumptions or plausible optimistic assumptions.

Also, the financial projections differ substantially from one 25-year period to another. Under all three assumption sets, the system runs a substantial surplus over the next 25 years. The OASDI payroll tax rate now scheduled for 1990 and thereafter is higher than the rate required for current-cost financing, whereas under either the intermediate or pessimistic assumptions, the rate scheduled for the period 2034-2058 is less than current-cost financing would require. The 75-year balance under the intermediate assumption set requires the accumulation of large surpluses in the period 1990 to 2015; these surpluses are then drawn down to cover annual deficits in the years 2034 to 2058. Just before the end of the projection period, the surpluses accumulated earlier will be exhausted and benefit payments can be continued only if taxes are increased or benefits are reduced. Also, under these assumptions, the accumulated OASDI trust fund balance rises to levels unprecedented in the history of the program. By 2015, the balance is projected to be about 25 percent of the gross national product.¹⁸ It remains to be seen whether future Congresses will allow accumulation of surpluses of this magnitude.

One reason such large surpluses might not materialize in the OASDI program is the currently projected financial situation in the payroll tax-financed Hospital Insurance program. HI is now projected to encounter financing difficulties beginning in the late 1980's or early 1990's and under all three assumption sets it faces a substantial deficit over the next 25 years; under the pessimistic assumption set, its 25-year deficit is greater than the surplus projected for OASDI. It is entirely possible that a future Congress will decide to cover a part of the deficit currently projected in the HI program by reallocating a portion of the payroll tax revenues now scheduled to go to the OASDI program after 1990.

¹⁸Calculated from the 1984 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors and Disability Insurance Trust Funds, Tables 31 and 33.

TABLE 7

1984 75-Year OASDI Income and Expenditure Projections

(Average annual total Projected Income and Expenses
as a Percent of Projected Taxable Payroll)

	Assumption Set		
	Pessimistic	Intermediate (B)	Optimistic
Old-Age, Survivors and Disability Insurance (OASDI)			
Full 75 years (1984-2058)			
Average Cost	17.22	12.95	10.01
Average Income	13.10	12.90	12.76
Balance	-4.12	-0.06	+2.75
First 25 years (1984-2008)			
Average Cost	11.63	10.54	9.36
Average Income	12.59	12.56	12.51
Balance	+0.97	+2.01	+3.15
Second 25 years (2009-2033)			
Average Cost	16.48	13.02	10.15
Average Income	13.13	12.97	12.85
Balance	-3.36	-0.05	+2.69
Third 25 years (2034-2058)			
Average Cost	23.55	15.29	10.52
Average Income	13.57	13.16	12.92
Balance	-9.98	-2.14	+2.40
Hospital Insurance (HI)			
25 years (1984-2008)			
Average Cost	5.59	4.25	3.32
Average Income	2.88	2.88	2.88
Balance	-2.71	-1.37	-0.44

Note: Totals do not necessarily equal the sum of rounded components.

Source: 1984 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, table 32, p. 77 and Summary of the 1984 Annual Reports of the 1984 Annual Reports of the Medicare Board of Trustees, table 4, p. 9.

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